

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS

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January 8, 2002

CODSIA Case No. 1 1-00

Ms. Sandra G. **Haberlin**

Defense Acquisition Regulations Council

OUSD (AT&L) DP (DAR)

IMD **3C132**

3062 Defense Pentagon

Washington, DC **20301-3062**

Subject: Changes to Profit Policy (**DFARS** Case **2000-D018**)

Dear Ms. Haberlin:

The undersigned members of the Council of Defense and Space Industry Associations (CODSIA) appreciate the opportunity to comment on the proposed rule **published** in the ***Federal Register*** on September 21, 2001 (66 Fed. Reg. 48649) and commend the DAR Council on its progress in developing changes to the weighted guidelines that **will** enhance the health of **the** defense industry. Formed in 1964 by industry associations with common interests in the defense and space fields, CODSIA is currently composed of seven associations representing over 4,000 member **firms** across the nation. **Participation** in **CODSIA** projects is strictly voluntary. A decision by any member association to abstain from participating in a particular activity is not necessarily an indication of dissent.

The Department of Defense (**DoD**) proposes to amend the Defense **Federal** Acquisition Regulation Supplement (**DFARS**) in order to revise **DoD's contract** profit policy in a manner that would reallocate the emphasis on performance risk and facilities capital investment.¹

Specifically, **DoD** proposes the following changes to the Weighted Guidelines Method (WGM) for establishing pm-negotiation profit objectives:

- Add general and administrative (**G&A**) expenses and contractor independent research and development and bid and proposal (**IR&D/B&P**) expenses to the cost base used to establish profit objectives for **performance risk** and contract type risk;

¹ The proposed rule replaces the proposed rule issued on **July 24, 2000** (***Federal Register***, Vol. 65, No. 12 1, pages 45574 - 45579). See **also** CODSIA letter, **September 29, 2000**.

- Increase the normal values and designated ranges for performance risk by one percentage point;
- Remove buildings from the facilities capital employed factor;
- Reduce the normal value and designated range for the equipment portion of the facilities capital employed factor by 50%; and
- Install a new cost efficiency factor that allows up to four percentage points for contractor cost reduction efforts,

The undersigned members of **CODSIA** are encouraged by the action taken by the new **administration** on issues identified in last year's Defense Science Board Task Force **Report**.² The Board had concluded that a competitive defense marketplace with financially sound companies that are able to attract excellent technical and management talent was essential. We strongly agree with that conclusion. While the Board **offered** recommendations in many areas, those directed specifically at **DoD's profit** policy *were as* follows:

- Use incentives to drive positive performance, allowing excellent performance to yield significantly higher profit margins;
- Revise profit guidelines so that **IR&D** is fee bearing;
- Revise profit guidelines to remove incentive to make rather than buy;
- Revise **profit** guidelines to reduce the reward for **fixed** assets and add a factor to reward contractor cost efficiencies; and
- Allow higher profit margins on successful defense contracts (e.g., excellent **cost/schedule/performance**, technical performance exceeding specification, etc.).

The actions proposed by **DoD** are generally consistent with the Defense Science Board recommendations, however, the **term** "revenue neutral" used by **DoD** in the public meeting to describe the desired result, stops short of the DSB recommendation for a change that would allow higher profit margins on **successful** defense **contracts**. In addition, **industry** analysis **of** the proposed change indicates that the WGM calculation would not produce a revenue neutral result, rather a result that would be reduced profit.

While a change to the weighted guidelines methods is appropriate, it must produce both a change in motivation aligned with the current business environment, and at the same time,

² Defense Science **Board** Task Force Report, "**Preserving a Healthy and Competitive U.S. Defense Industry to Ensure our Future National Security**," November, 2000.

provide a calculation for profit and fee rates that reward an industry **with the** opportunity for solid returns. Consistent with **these** objectives, **the following** recommendations must be considered and addressed in the proposed rule change:

Facilities Capital

Some of our member's companies are **concerned with** the proposed reduction in emphasis on facilities. If implemented as proposed, we believe the industry will be penalized in comparison **with** the existing policy. While we recognize that some companies may have excess **facilities** and would benefit **from** the reduction of emphasis on facilities, other companies have made, and will continue to make, significant investments in facilities that **are** needed for **efficient** performance of defense contracts. **We** recommend **DoD** not **reduce** the normal range and designated range for **the** equipment portion of the facilities capital employed factor by 50%. To do so undermines the incentive for contractor investment **in** equipment modernization. **In** addition, remaining with the current equipment weighting would address **the** industry's concern **that** there is a "less than revenue neutral" result with the rule as proposed.

Cost Efficiency

We support the addition of the cost **efficiency** factor. The objective of the factor is stated **as** a "special factor to encourage cost reduction efforts." Cost reduction is beneficial to **the** Government whether it is at **the** enterprise level or at the level of a specific contract. As noted above, industry also believes strongly **that** this **factor** and its use in **the** calculation must be revised to insure the WGM produces **the** intended result. These revisions include:

- **This** factor should **not** be restricted to the "pending **contract.**" Instead, it **should** be expanded to consider long term cost reduction and productivity criteria with wider application. It **could** be revised as follows: "...evaluate the benefit the contractor's cost reduction efforts will have on pending **and/or subsequent contract(s) or overall cost to the Government . . .**". Consistent with this revision, it is recommended **that** the factor be renamed "Productivity **&** Cost Efficiency" to reflect this broadened view. A time **frame** should also **be** specified over **which** contractors' macro cost reduction efforts **would** be considered.
- The cost **efficiency factor** must be considered a mandatory element in **the** contracting officer's evaluation -not simply "to determine if using this factor is **appropriate**" proposed **215.404-71-5(b)]**. A requirement to employ **cost** efficiency as a profit factor will help **assure** industry that its cost efficiency efforts are important and recognized and will be given due consideration in each profit/fee assessment.
- It is important that it be clearly **communicated** in the guidelines how various **actions** and accomplishments will be translated into **actual** profit recognition. The current guidelines provide examples of areas of consideration but do not provide guidance as to what level

of action or accomplishment equates to a specific percentage of the scoring. Other **factors** in the guidelines provide indicators for receiving above or below normal ratings. Consistent with this format, the guideline should provide clear indicators for normal, above normal and below normal ratings.

- Consistent with our remarks on facilities capital, we recommend that there be an element **within** this cost **efficiency** factor that would recognize new facilities where appropriate to provide credit for investment in buildings, but only when such investments contribute to better asset utilization or improved productivity, or are demonstrated to be vital to the contract or program under consideration.

With these changes, we support this new cost efficiency factor. We, however, remain concerned that the factor could suffer **the** same fate as the previous "special productivity factor." That factor was found by **DoD** not to be credible and rarely to have been used by contracting **officers**, which is why it was eliminated. A more recent example is the technology incentive factor for performance risk that was implemented on December 13, 2000. We have seen infrequent use of this incentive as confirmed by the recent GAO report (GAO-01 O-80 1, Use of Profit Policy to Promote Innovation, dated July 26, 2001). These typos of incentives, whether for technology or cost efficiency, must be utilized consistently to achieve the **DoD** desired result and the Defense Science Board recommendations.

Training for Implementation

The training of the acquisition work force and industry counterparts is essential for success and achievement of the desired result. A key objective of the training activity must be developing an understanding among the acquisition workforce of the "**macro economics**" of the defense marketplace and its industry. Members of our associations **stand ready to partner with DoD** in developing and deploying an effective training and education effort to implement this change.

We appreciate the opportunity to comment on the proposed rule and **look** forward to working with the DAR Council. We encourage you to press forward with the proposed rule and incorporate our recommendations. Additionally, industry pledges its support in working with **DoD** on the **training** and implementation action plans.

If you have any questions or need additional information, please contact Patrick Sullivan, the CODSIA Project Officer for this case, at (202) 371-8522.

Sincerely,

(SEE ATTACHED CODSIA SIGNATORIES)

